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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992	)	MM Docket No. 92-266
Rate Regulation	)	

PETITION FOR RECONSIDERATION
OF CONTINENTAL CABLEVISION, INC.

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List A B C D E

TABLE OF CONTENTS

SUMMARY

Continental submits that the Commission erred in establishing a benchmark system that treats satellite tier rates no differently than rates for basic service. The statute prescribes different systems of regulation for basic and tier rates. The express language of the Act measures basic rates against markets with "effective competition" but directs the Commission, when evaluating satellite tier rates, to look to rates of all "similarly situated" systems, whether or not in competitive markets. The legislative history of Section 623 consistently demonstrates that Congress intended that satellite tier rate regulations were intended to correct abuses by "renegades" and "bad actors" through case-by-case complaints.

The Commission has no basis for its conclusion that the benchmark rates are compensatory, has ignored evidence that systems subject to "effective competition" are unprofitable, and has effectively denied rational recourse to cost of service alternatives. As a result, the system discourages network modernization, discourages the addition of high quality networks, dismantles low cost lifeline tiers, punishes good actors and rewards bad actors. The Commission's "tier neutral" benchmark system is therefore arbitrary, capricious and confiscatory.

The solution is for the Commission to tie permissible rates for cable programming to the rates of all comparable systems. Indeed, the margin of error in the FCC's sample compels this solution, at minimum.

The current regulations correctly permit "pass throughs" of certain "external" cost, but must be revised to include increased cost attributable to required system upgrades and other uncontrollable costs. External treatment should be accorded to costs arising or incurred after September 30, 1992, and should be able to be passed through on a current basis, without a need for an annual rate review.

There is no record evidence supporting the Commission's decision to prohibit rate increases from affiliated programmers. The rule will punish Continental for launching New England Cable News Channel with Hearst, and will arbitrarily deny Continental pass through of substantial programming costs on an unproven theory that incidental nonattributable ownership in programmers will lead MSO's to inflate programming costs to take immaterial "benefits" from the programming side. The Commission should treat <u>all</u> programming cost increases above GNP-PI as "external."

California's possessory interest tax is a tax of special applicability to cable operators, and should likewise be treated as "external" and subject to pass through.

Continental asks the Commission to reconsider Worksheet 3 of Form 393, which reduces the permitted service rate by equipment cost, although most customers will not pay the full cost of installation. Operators should not be penalized for installation discounts, and the Commission should revise Worksheet 3 to remove from revenue calculations installation income which is not expected to be earned during the coming year.

Continental believes the Commission's treatment of MDU bulk billing contracts ignores the competitive market for these agreements, and should be reconsidered. The Commission should grandfather existing commercial and MDU contracts, and allow cable operators to continue to meet competition to the benefit of consumers.

The Commission should rule that equipment necessary only to deliver premium or satellite tier services is not regulated as basic service. The statute and its legislative history leave no doubt that Congress intended separate regulation of such equipment. Moreover, the Commission's ruling threatens deployment of new digital equipment needed to deliver new deregulated services but theoretically "used" as well for basic.

Continental asks the Commission to revise its requirement that rates cannot be advertised unless they include franchise fees. The rule fractionalizes marketing, and ignores the different treatment of franchise fees by communities served by an integrated cable system. The regulation does not prevent confusion of subscribers, but in fact promotes such confusion. Numerous other services and goods are advertised at a price exclusive of taxes and other "ad-on" charges. Apart from these practical difficulties, the regulation violates Continental's First Amendment rights. The Commission should permit advertisement of cable rates exclusive of franchise fees and taxes.

Continental asks the Commission to reconsider

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543(c)(2)(A). The Commission effectively ignored this primary criterion, by limiting its consideration to how different all rates are from rates in areas subject to effective competition. It then chose to treat the entire industry as "renegades" for exceeding rates the Commission predicts for markets with effective competition. By collapsing satellite tier standards into basic rate standards, the Commission turns the Act upside down, and ignores all the remaining statutory standards, including: how historical increases in satellite tier rates compare with the CPI; the "capital and operating costs of the cable system, including the quality and costs of the customer service provided by the cable system;" and "the rates as a whole, for all the cable programming, cable equipment, and cable services provided by the system."

Both in the House and Senate, sponsors of the legislation and others repeatedly explained that the tier rate provisions were designed "to rein in those renegades," to curb "bad actors," and to provide "case by case" complaints against "cable operators who are engaged in persistent and continuous misbehavior."[1/] Congress easrejected such a system. 138 Cong. Rec. S14224 (September 21, 1992) (Dingell).

The Commission has erred fundamentally in overturning that Congressional choice.

B. The Record Reveals No Rational Basis For Treating Basic And Discretionary Satellite Tiers Identically

The Commission has explained that it did not intend to adopt noncompensatory regulations. But there is no basis for the Commission to claim that the rates it projects for systems subject to "effective competition" "presumptively recovered costs" (R&O at ¶ 387 n. 946) for all systems with equal numbers of subscribers and channels.[2/]

"average variable" cost, below which antitrust law presumes that rates are unlawful.[3/] "Average variable cost" recovers neither capital costs nor return on investment.[4/]

In municipal overbuilds the goal is not to make a return on investment, but to run a tax free business at breakeven: "our cable business is not designed to produce revenue; it's designed to produce a service, to break even."[5/]

Systems with low penetration are often less compensatory. Continental's South Central Los Angeles system is subject to "effective competition." The system's 1992 operating losses exceeded $2.6 million, with losses through December 31, 1992 totaling over $15.5 million. It will be many years before the South Central system becomes profitable, and it is irrational for the FCC to use the rates of the South Central system, and similar systems, as a "presumptively" compensatory benchmark rate for satellite tiers provided by Continental and other cable operators.

Although the Commission declared "We do not believe that the required rate reductions will hinder the ability of the cable industry to provide quality services to consumers," R&O at ¶ 9, it offered no foundation for either its "presumption" or "belief" as to the effect of the satellite tier rate regulations on cable operators. The record contains none.

3/ III Phillip Areeda & Donald F. Turner, Antitrust Law ¶ 715c-d (1979).

4/ Antitrust Law at ¶ 715c.

5/ "In Glasgow (KY), the Accent's on Competition," Multichannel News, January 25, 1993, pp. 347.

C. A "Tier Neutral" Scheme Creates Irrational Incentives

The Commission's fundamental error has been exacerbated by its failure to understand the operations of overbuild markets from which it has drawn its baseline. Overbuilders engaged in price wars do not make the incremental distinctions of channel capacity reflected in the benchmark tables: a 54 channel system will under-price a 36 channel system as part of the initial rate wars. As a result, the benchmark prices adopted by the Commission show a drastically declining price per channel providing almost no compensation as capacity is increased. The limits on "external" pass throughs leave "system upgrade" rebuild costs unrecovered outside of the benchmarks. The application of that model to satellite tiers is devastating. In a stroke, the Commission has discouraged network modernization and the addition of high quality cable networks -- for which Congress and the FCC have elsewhere congratulated the cable industry.[6/]

The Commission's insistence on "tier neutral" pricing, its indiscriminate 10% cut in satellite tier rates, and its imposition of price caps with no record of underlying costs serve almost perfectly to defeat the Act's goals. Operators who have been efficient in controlling costs, and who thus have kept rates low, are punished by price caps, and prevented from charging even the "competitive" rate. Ironically, renegades and bad actors are rewarded

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6/ See, e.g., H.R. Rep. No. 628, 102d Cong., 2d Sess. at 29 (1992).

with 90% of already outlier rates. Responsible operators, whose rates reflect a reasonable balancing of costs and demand for cable programming services, are punished with 10 percent cuts. Lifeline basic services are required to be inflated in price or discontinued. The Commission's rules, if left unchanged, will reverse decades of pro-investment, incentive, and pro-consumer policies.

D. The Commission's Rules Effectively Deprive Cable Of Cost Of Service Regulation As A Fallback

Cost of service provides no viable alternative to the benchmarks. The FCC has given no guidance as to what rules and standards will govern cost of service justifications, and instead has left that difficult task for yet another rulemaking proceeding to be commenced at some future date.[7/] R&O at ¶¶ 10, 272. The Commission merely warns operators: "the fact that an operator has incurred costs does not necessarily establish a right to recover those costs from subscribers;" R&O at ¶ 400 n. 977; and that it will affirm any "rational" rate decision by a franchising authority, including one that falls below benchmarks, if an operator dares to submit a COSS. R&O at ¶ 149.

Because there is no meaningful cost of service safety valve, and will apparently be none before the effective date of the rules, the benchmark system is arbitrary, capricious and confiscatory.

7/ It is impossible for the Commission to issue a Notice of Proposed Rulemaking, receive comments and replies, and issue final regulations in time for operators to consider cost of service as an alternative to the benchmarks before the October 1, 1993 effective date of the rate regulations.

II. CABLE PROGRAMMING SERVICE BENCHMARKS MUST BE DECOUPLED FROM BASIC BENCHMARKS

Continental submits that the Commission may right its error only by measuring cable programming service rates against rates from all comparable systems. Only that will preserve the revenue streams essential for developing product, capacity, and offering consumer choice. Tiers are fundamentally optional services: There is no basis for treating all providers of optional tiers as though they were industry renegades.

Yet it is not enough to shift the universe to all systems if the Commission continues to focus on average rates. There is a margin of error in the Commission's sample for which the Commission has not accounted. If a rate higher than an all-system benchmark is statistically identical to the mean, it should be deemed reasonable.

With these changes, the Commission would fulfill the commands of Congress to maintain low basic rates but rein in the renegades on satellite tiers, while acknowledging the real world consequences of relying on data sampling (and its inherent range of error) to establish rate benchmarks.

III. EXTERNALLY IMPOSED COSTS

A. General

Any benchmark system must also account for "externals." The Commission's present treatment of "externals" starts with the appropriate premise -- that significant costs should be recovered as pass throughs without resort to elaborate cost of service proceedings. But the Commission fails to deliver a workable mechanism. We are left with a collection of staggered implementation dates, in which uncontrollable third party costs, such as PEG access support, are "lost" if they were incurred after the September 30, 1992 baseline but before City regulation or FCC complaint; where costs incurred thereafter may be recovered only at staggered intervals, depending on the vagaries of complaint timing and whether a prior rate case was begun less than a year before the cost; and where certain costs, like uncontrollable pole rent increases and desirable investments in systems upgrades, are never recovered.

System upgrades are essential if the cable industry is to contribute to the nation's information superhighway. More prosaically, system upgrades are commonly required for operators to satisfy franchise renewal standards and thereby remain in business. The present system of "externals" fails to compensate cable operators for the investments which are critical to the nation's infrastructure and to cable's future. The result is surely to be repressed investments, unfairly unrecovered costs, needless cost of service cases, or "gaming" of the unfair system to work a fair result.

Continental believes the Commission may make sense of all of this with some simple reforms: (1) externals should be redefined to include system upgrades required by franchise[8/] and

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8/ Examples are added channel capacity, I-Net, and establishment of a new walk-in office, where the franchising authority elects to require one.

uncontrollable third party costs like pole rent; (2) externals should be treated as flow throughs if they arise or are expended at any time after September 30, 1992; (3) externals should be allowed to be immediately flowed through (without awaiting an annual rate adjustment cycle).

B. Program Cost Increases Should Be Treated As "External" For Affiliated MSOs

Without notice <u>or</u> <u>any</u> record evidence, the Commission has presumed that every rate increase from an affiliated programmer is a subterfuge, and must be denied external pass through. Two brief examples demonstrate the irrationality of that presumption.

In 1992, Continental and Hearst Corporation launched the 24 hour New England Cable News Channel ("NECN") to provide continuous 24 hour news coverage of events in the six New England states.[9/] The Commission's rule penalizes Continental and Hearst for taking the risk in launching this innovative local news afloat. The new regulations essentially cap the channel in its start-up years at a rate slightly below inflation, at a time when advertising dollars are most difficult to obtain. The Commission's own record, R&O at pp. 596, 597, shows that this is a prescription

The Commission seems to have departed from this paradigm in its treatment of California's possessory interest tax. In California, where Continental serves more than 500,000 cable subscribers, cable operators are assessed not only the 5% franchise fee, but a tax on the "possessory interest" value of the franchise to occupy the public property -- for which the 5% fee has already been assessed. California's assessors, who are elected public officials, have singled out cable television for a unique and radical valuation for the possessory interest tax. It is not that other businesses are not assessed the tax: it is that only cable has been taxed on virtually the entire value of the business as a going concern.[10/]

Two cases currently in litigation illustrate the impact of this tax onslaught. Following a 1987 reassessment, Viacom Cable's California division incurred a 27 fold increase in its possessory interest valuation.[11/] In Orange County, ten cable television operators filed suit in 1990 after their combined tax liability jumped from $2 million in 1988-89 to more than $11 million in

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10/ Ignoring Revenue and Tax Code § 107.7's preferred method for valuing cable television possessory interests (i.e., capitalization of the franchise fees), many California assessors treat cable television systems as a single unit of appraisal, measured by an estimate of the system's value as an operating enterprise. From this total, a portion is allocated to taxable personal property and fixtures (generally based upon a replacement cost new, less depreciation). County of Orange v. Orange County Assessment Appeals (1993) 13 Cal.App.4th 524, 16 Cal.Rptr.2d 695 (1992). The entire remaining system value is then attributed to the taxable possessory interests.

11/ As reported in Multichannel News, August 19, 1991, page 2.

1989-90.[12/] These astronomical increases have in most cases been passed directly through to subscribers, increasing their bills by as much as $2.50 per month.[13/]

Cable television operators have been singled out for this unique application of the possessory interest tax; it is not applied to other similarly situated California businesses, and is foreign to nearly all other states. It is an industry specific tax and cannot be considered a tax of general applicability. By treating the possessory interest tax as just one more general business expense, the Commission has forced affected California operators to enter the Form 393 with rates inflated by government assessments, then take a 10% cut not only in the "real" retail rate but in the recovery of these taxes. Continental believes it should be considered a completely "external cost" like a sales tax and be allowed to be passed through in total without need for prior regulatory review. Indeed, local regulatory review would be meaningless.

IV. DISCOUNTED INSTALLATION SHOULD NOT BE PENALIZED

Worksheet 3 of the Form 393 automatically reduces the maximum initial permitted rate by the amount of equipment "cost" derived from Part III of the Form. In reality, even though an installation may "cost" $40 to $100, most customers will not pay the full amount. In a market-driven world, that price is reduced

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12/ Multichannel News, May 28, 1990, page 5.

13/ Multichannel News, May 28, 1990, page 51 (Available on NEXIS).

through discounting, packages, and promotions, so that the collected revenue may be a fraction of the "cost." The Commission's regulations do not change the market reality that cost-based installation serves as a marketing barrier to new subscribers, yet the Form reduces the service rates as though customers were paying full cost for installation. This unfairly penalizes operators for trying to attract new subscribers. The Commission should not be imputing phantom revenues to operators who do not collect them. The simple solution is to revise Worksheet 3 so that the equipment "cost" removed from the initial base rate is adjusted to remove installation income which is not expected to be earned during the forthcoming year. The reasonableness of the estimate may be measured against the same historic data used to calculate the Equipment Basket.

V. DISCOUNTS FOR BULK BILLING OF MDUs SHOULD BE PERMITTED BECAUSE THEY RESULT FROM COMPETITION

The Commission's interpretation of "uniform rate" places cable operators in a precarious position: they must breach ongoing commercial and MDU contracts; and they must risk losing substantial business to unfair competition by private cable operators that operate without franchise obligations and who will under-price the regulated price umbrella. Continental is party to hundreds of commercial and MDU agreements, many inherited through acquisitions, others negotiated in a market made fiercely competitive by private cable and developer dishes. The vigor of the competition for MDU agreements is evident through court decisions,[14] and Continental's

14/ See, e.g., Cable Investments, Inc. v. Woolley, 867 F.2d 51 (3d experience. See Exhibit A. These contracts have years to run, yet the Commission is apparently expecting them to be unilaterally adjusted in mid-term without any reference to the market reality: the contracts are still in force (absent Commission preemption and force majeure) and, even if they are superseded, cable operators will lose the market if they are unable to meet competition.[15/]

It is particularly unusual that the Commission would establish a pricing scheme which invites private cable to skim off commercial and MDU accounts (by forbidding franchised cable competition). After all, the Commission just won an important Supreme Court case which extends FCC and franchise regulation to interconnected SMATV's on the theory that this was necessary to prevent unfair competition.[16/] The simple solution is to grandfather existing commercial and MDU contracts, and to allow cable operators to continue to meet competition in this highly competitive market. Such a ruling will only benefit consumers. Single family residential prices would continue to be set by benchmarks,

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[Footnote Continued]

633 F. Supp. 1315 (D. Del. 1986); Greater Worcester Cablevision, Inc. v. Carabetta Enterprises, Inc., 682 F. Supp. 1244 (D. Mass. 1985).

15/ The antitrust laws expressly permit an incumbent with market power to reduce price to meet competition. See, e.g., 15 U.S.C. § 13(b) (Robinson-Patman Act); ILC Peripherals Leasing Corp. v. IBM, 458 F. Supp. 423, 433 (N.D. Cal. 1978), aff'd, 636 F.2d 1188 (9th Cir. 1980), cert. denied, 452 U.S. 972 (1981).

16/ FCC v. Beach Communications, Inc., 61 U.S.L.W. 4526, 4529-30 (1993).

and MDU residents would benefit from the operation of actual marketplace forces.

The R&O suggests that the Commission is powerless to "deregulate" MDU prices in markets without effective competition. But the Cable Act already deregulates the submarket of premium services offered by operators with putative market power over basic and expresses its preference for market solutions. The Act cannot be so inflexible as to prohibit the same treatment of the MDU submarket which operates in actual competition.

VI. EQUIPMENT USED TO DELIVER PREMIUM OR SATELLITE TIER SERVICES SHOULD NOT BE REGULATED AS PART OF THE BASIC SERVICE

The Commission's decision to force all subscriber equipment into the category of "basic" service priced at actual cost may serve the ends of administrative convenience, but it most assuredly does not comport with the statute. The statute directs that "equipment used for" basic is regulated locally, while "equipment used for" the program service tier is subject to complaint at the FCC. 47 U.S.C. §§543(b)(3)(A), 543(l)(2). In Conference, Congress specifically amended the definition of "program service tier" to include equipment. Conf. Report at 66.

The Commission's interpretation of Section 623(l)(2) to provide for FCC jurisdiction only over equipment used "solely" to receive satellite tiers renders meaningless Congress' amendment to include equipment in the satellite tier definition. Section 623(b)(7) requires that every subscriber take basic service to receive any tier; consequently, there is no converter that would be used solely to receive the satellite tier, or a deregulated sermarket already exists. This would include nonaddressable converters, and associated remote control devices for which universal remotes are substitutable. The Commission's decision to require unbundling of all subscriber equipment assures that subscribers will be protected by price competition in the marketplace.

VII. SERVICE RATES NEED TO BE MARKETED EXCLUSIVE OF FRANCHISE FEES

The Commission's prohibition against advertising service prices which do not specify the amount of franchise fees, R&O at ¶ 551 n. 1415, essentially prohibits integrated systems serving multiple communities from using mass media to advertise rates. Continental's Dayton area system is franchised in 58 different communities, yet the system is managed and operated on an integrated basis of 160,000 subscribers. The rule would require dozens of different prices to be quoted for an integrated system sharing common plant, expenses, and services, but which serves communities with strikingly different attitudes about the franchise fees which should be charged to cable subscribers. See Exhibit B. The marketing impact is completely diluted, and confusion is the result. Since local newspapers, radio and television traverse franchise boundaries, it is impractical for Continental to tailor advertisements to each community of the system, where individual community sizes may range from less than 200 subscribers to over 60,000.

operators are required to provide "needlessly fractionalized marketing," decried elsewhere in the same R&O. R&O at ¶ 29.

Consumers will not be "needlessly confused" by advertisement of rates exclusive of franchise fees and taxes, R&O at ¶ 551 n. 1415, because consumers are accustomed to such marketing. The FTC permits advertisement of rates exclusive of taxes even when it has required disclosure of all mandatory and unavoidable service charges. See, e.g., Dollar Rent-A-Car, Inc., FTC Docket No. C-3421 (March 29, 1993). Sporting events, concerts, airlines, automobiles, restaurant promotions, and goods sold through national or regional advertising often specify a price exclusive of applicable taxes, shipping and handling or transaction charges. In truth, it is the only way for these businesses, and Continental, to efficiently market on a regional basis while insuring that consumers receive accurate rate information.

The First Amendment protects truthful commercial advertising, see, e.g., City of Cincinnati v. Discovery Network, Inc., 61 U.S.L.W. 4272 (1993), and prohibits the Commission's marketing requirements. Where government seeks to decree the content of truthful commercial advertising, it must demonstrate a "reasonable fit" between its regulation and its purported goals. Board of Trustees of State Univ. v. Fox, 492 U.S. 469, 480 (1989). The

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[Footnote Continued]

tion. Since subscribers are billed in advance of receiving service, customers would be fully informed of all charges before incurring any obligation.

Commission's cable rate marketing standard is intended to avoid "needless confusion," R&O at ¶ 551 n. 1415, yet that is exactly the result. There is no "fit" between the regulatory means and ends, and the requirement therefore violates Continental's First Amendment rights.

The Commission should therefore permit operators to market common retail cable rates exclusive of franchise fees and taxes.

VIII. OPERATORS SHOULD BE PERMITTED TO USE SYSTEM DATA TO AVERAGE RATES

Virtually all aspects of cable television are integrating into larger regional networks, just as originally forecast by FCC cable orders. Headends interconnect community units, fiber integrates headends, centralized customer service centers deliver 24-hour service, statewide and multistate technical centers provide for sophisticated training, repair, and management, and soon regional consolidations will create large networks matching ADI or LATA boundaries. Yet the most recent iteration of Form 393 requires operators to develop prices community unit by community unit, however archaic and arbitrary the result.

Consider Continental's handling of equipment in New England. Continental serves over 625,000 subscribers in New England, with centralized purchasing, inventory, and repair for converters. According to the Form 393, the inventory which happens to be parked in a warehouse at one system is captured in the financials for that system, more than doubling the converter rental for